

Legislative Audit Division

State of Montana



Report to the Legislature

October 2006

Financial-Compliance Audit

For the Two Fiscal Years Ended June 30, 2006

Department of Revenue

This report contains seven recommendations to the department. Issues addressed in the report include:

- ▶ Financial Accountability
 - Reconciliation controls
 - Unrecorded revenue and expenditures
 - Debt collection program
- ▶ Improving tax compliance for:
 - Combined oil and gas severance taxes
 - Corporation license taxes
 - Individual income taxes
- ▶ Noncompliance with state statutes

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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Findings and Recommendations

Improving Tax Compliance

The department is responsible for the administration and enforcement of many of the state's tax laws. We found the department could change procedures to improve taxpayer and department compliance with state tax laws related to combined oil and gas severance, corporation license, and individual income taxes.

Combined Oil and Gas Severance (COGS) Taxes

The department does not have adequate procedures to ensure COGS tax liabilities are reasonable for producers that are not the largest producers and to immediately estimate taxes for COGS nonfilers, as required by section 15-36-313(1), MCA.

Production and Sales Reporting Discrepancies

COGS collections were \$126.8 million and \$192.8 million in fiscal years 2004-05 and 2005-06, respectively. COGS producers are required to file and pay taxes, based on reported production and sales data, quarterly. The department's audit function provides a means for the department to examine taxpayers' financial records to determine whether they have accurately calculated and reported their tax liabilities. Only the largest producers, representing approximately 85 percent of total reported COGS tax revenue, receive audits that verify production and sales data.

The Board of Oil and Gas Conservation (BOGC) requires oil and gas producers to report production and sales data monthly. In the past, the department cross-matched data received with quarterly tax returns to the data provided to the BOGC and followed up large or unexpected differences through contact with the producer. Department personnel indicated they do not currently have the staff resources to perform these procedures. Comparing tax return information to the BOGC data may help the department identify unreported COGS tax liabilities.

We compared production and sales data that six producers reported to the department through quarterly tax returns to the production and sales data those producers reported to the BOGC for the same period. We found discrepancies for three of the six producers tested: three discrepancies for gas and two for oil, ranging from 7 to 48 percent of the amounts reported to the department on tax returns. In

Findings and Recommendations

all but one case, the producer reported higher oil and gas production data to the department than to the BOGC.

We also compared the department's listing of taxpayers by lease unit for the fourth quarter of 2005 to the BOGC's listing of operators by lease unit for October through December 2005. We compiled a partial list of the operators and leases that were on one listing but not on the other listing and asked department personnel to research these differences. They found four of the operators on the BOGC's listing that were not on the department's listing had not filed tax returns. They also found a fifth operator had not filed taxes for two lease units reported to the BOGC that were not reported to the department. Based on these results, department personnel indicated in June 2006 that they have started to perform this cross-match again.

Assessing COGS for Nonfilers

When COGS taxpayers fail to file taxes within the time required, the department is required by section 15-36-313(1), MCA, to ascertain the amount of oil and gas produced and sold during the quarter and each month of the quarter, immediately after the time for filing has expired. The department is also required to determine the average value of the oil and gas produced and sold, and to fix the amount of taxes due for the quarter.

In June 2006, the department was identifying, contacting, and estimating taxes for nonfilers for the quarter ended September 30, 2005. Department personnel stated they do not have the staff resources to estimate tax liabilities immediately after the time has expired. The department should work with the BOGC to develop procedures to facilitate efficient comparison of oil and gas production and sales information by operator and lease.

Recommendation #4

We recommend the department work with the Board of Oil and Gas Conservation to develop and implement procedures for cross-matching oil and gas production and sales data to ensure all oil and gas severance taxes owed are reported or assessed in accordance with state law.

Findings and Recommendations

Income Limitation for Dependent Exemption

Each tax year, the department publishes an individual income tax booklet to help taxpayers prepare their Montana taxes. This tax booklet contains information on the criteria that must be met in order for the taxpayer to claim a \$1,900 exemption for a dependent. One of the criteria defining a dependent in the 2005 tax booklet is a person other than a child of the taxpayer "... who does not have gross income of more than \$1,900" Section 15-30-112(5)(a)(i), MCA, states "... an exemption of \$1,900 is allowed for each dependent: (i) whose gross income for the calendar year in which the tax year of the taxpayer begins is less than \$800; or (ii) who is a child of the taxpayer"

Section 15-30-112(6), MCA, requires the department, by November 1 of each year, to multiply all exemptions provided in this section of the law by the inflation factor for that tax year. The department has been applying the inflation factor to the income limitation of dependents other than taxpayers' children, as well as to the exemptions, since 1980 and believes that it is appropriate to adjust the income limitation for inflation. As a result, the department has been allowing exemptions for dependents that are not provided for in law. The amount of such exemptions is not known, because these exemptions are not reported and tracked separately from other dependent exemptions.

Requirements not in Individual Income Tax Booklet

The following laws that could either benefit the taxpayer or disclose compliance requirements to the taxpayers were not included in the 2005 tax booklet.

- 1) Section 15-30-105(2), MCA, discusses an alternative tax calculation option for non-residents.
- 2) Section 15-30-121(1)(i), MCA, discusses the deductions that are allowed for livestock fees that have been imposed on the taxpayer by other sections of state law.
- 3) Section 15-30-106, MCA, discusses imposition of a tax on the portion of a lump-sum distribution allowed as a deduction by section 62(a)(8) of the Internal Revenue Code.

Findings and Recommendations

- 4) Section 15-30-142(3), MCA, discusses the preparation and signing of a return by someone other than the taxpayer when the taxpayer is unable to prepare their own return.

The department expanded the tax forms in the 2005 tax booklet from the forms in the 2004 booklet in order to reflect all features of Montana law. Department personnel indicated items (1) and (2) above would apply to a very small population; item (3) was a line item in the 2004 tax booklet, but was excluded from the 2005 booklet and taxpayers who called to ask where they should include this information were told to put it on the line for the rural physician credit; and item (4) could be clarified. By excluding the information contained in the laws discussed above from the tax booklet, the department increases the risk that taxpayers will not be aware of the related requirements or options and may prepare their return or calculate their tax liability incorrectly.

Recommendation #6

We recommend the department:

- A. Comply with section 15-30-112, MCA, concerning the income limitation of dependents other than taxpayers' children.**
- B. Improve the tax booklet by including all information affecting individual income tax computations contained in state law.**

Other State Compliance Issues

The department is not in compliance with certain state statutes and certain statutes affecting the department's operations are out of date.

Section 15-1-201, MCA, provides the department has general supervision over the administration of many of the assessment and tax laws of the state. During this audit, we tested the department's compliance with approximately 230 state laws and appropriation restrictions. In addition to the previously noted instances of noncompliance with state law, we found the department did not

Findings and Recommendations

additional penalties only when it is very clear the taxpayer purposely failed to file a tax return or pay a tax when due. As a result, these units do not comply with the requirements of the additional penalties law.

Statutory Housekeeping

The following statutes affecting the department's operations are out of date.

Municipal Corporations

As discussed in our prior audit report, section 15-1-201(3), MCA, requires the department to collect information on expenditure of public funds for all purposes from officers of municipal corporations to assist the department in its work. Department personnel noted they no longer collect this information because it is not needed. We determined the department is in substantial compliance with section 15-1-201, MCA, but should seek legislation to amend this statute to reflect the current information needs of the department.

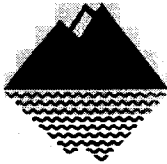
Statement of Coal Sales

Section 15-35-104, MCA, requires each coal mine operator to provide a statement of the tons of coal sold to each purchaser for the quarter. The department has not required coal mine operators to provide this statement for several years, because the tax is no longer based on this information. Therefore the forms and instructions provided by the department for coal taxes do not contain this requirement. The department should seek legislation to amend this statute to reflect its current information needs.

Recommendation #7

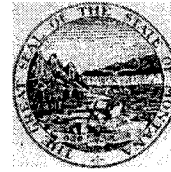
We recommend the department:

- A. Centrally assess cellular phone companies as required by section 15-23-101, MCA.**
- B. Implement procedures and administrative rules to provide consistency in assessing additional penalties for purposely failing to file or pay taxes when due, as required by sections 15-1-216(1)(b) and (1)(d), MCA.**
- C. Seek legislation to amend sections 15-1-201 and 15-35-104, MCA, to reflect the department's current information needs from municipal corporations and coal mine operators.**



Dan Bucks
Director

Montana Department of Revenue



Brian Schweitzer
Governor

October 19, 2006

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LEGISLATIVE AUDIT DIV.

Scott A. Seacat, Legislative Auditor
Legislative Audit Division
Room 160, State Capitol
P.O. Box 201705
Helena, MT 59620-1705

Dear Mr. Seacat:

We appreciate the opportunity to respond to the recommendations raised in the Financial Compliance Audit Report of the Montana Department of Revenue for the fiscal years ended June 30, 2005 and 2006. Our response to the recommendations included in the audit report is as follows:

Recommendation #1

We recommend the department implement controls to ensure daily reconciliations of receipts to amounts recorded on its taxpayer systems are complete and accurate.

Concur. The Processing and Retention Operations (PRO) area has already started making changes to comply with this recommendation. We have improved our form layouts for reconciliation to SABHRS and reconciliation for deposit collections. The new form layout contains the necessary fields to track payment information received from various sources and tracks daily and month-to-month reconciliations.

A quality assurance step has since been implemented in which the team lead and unit manager verify totals on a weekly and monthly basis and ensure the accuracy and completion of reports. The cashiering unit will also work with the accounting staff in the Citizen Services and Resource Management Division for a periodic review of the daily reconciliations. This will provide an independent review of the process and a means to recommend any improvements.

A daily checklist for money not reconciled has since been created so staff will know the appropriate steps to locate and/or correct discrepancies. This process will supplement the quality assurance step previously described.

Recommendation #4

We recommend the Department of Revenue work with the Board of Oil and Gas Conservation to develop and implement procedures for cross-matching oil and gas production and sales data to ensure all oil and gas severance taxes owed are reported or assessed in accordance with state law.

Partially Concur. The department agrees to work with the Board of Oil and Gas Conservation (BOGC) on the development and implementation of a process to systemically cross-match BOGC well data with department tax data. To accomplish this, the department will: 1) work with BOGC on the development of the data requirements to conduct the cross-match; 2) enter into an MOU with BOGC which will contain the data requirements, timelines and responsibilities; and 3) work with the department's programming staff to develop electronic non-filer and/or missing lease letters. It is anticipated this process will be in place by the end of 2007.

The audit noted the department was not complying with the provision of 15-36-313 (1), MCA, which requires the immediate issuance of an estimated tax assessment for operators who have failed to file an oil and gas production tax return. The department believes that while estimated tax assessments are a useful enforcement tool, there are more efficient and effective ways to enforce compliance. These other enforcement tools include issuing administrative subpoenas and orders to show cause for non-filing. The department intends to continue to use estimated tax assessments when appropriate, but will be focusing on enforcement by using these other tools. To specifically address the audit findings, the department will seek legislation to strike the requirement to immediately issue an estimated assessment. The proposed legislation will continue to give the department the authority to issue estimated assessments when appropriate.

Recommendation #5

We recommend the department:

- A. Work with the Secretary of State to obtain the information necessary for an efficient comparison of new entity information.

Concur. The department is working with the Secretary of State in order to receive approximately seven additional files which will include data the department has been missing. This process is limited to an initial comparison by name only. In order to make this an efficient process; however, the Secretary of State would need to require a taxpayer identification number; i.e., federal employer identification number or social security number which they do not currently require. Otherwise, the comparison process has marginal value.

In the June 2006 Performance Audit titled "Improving Taxpayer Compliance in Montana Through Audit Efforts" the Legislative Auditor recommended that the department:

Establish priorities for achieving audit goals and objectives, and more effectively deploy audit resources by directing audit activities. The department will continue to work with data provided by the Secretary of State. As long as SSN/FEIN numbers are not required by the legislature or the Secretary of State; however, this data will likely have marginal value and will not be assigned as high a priority for compliance use as other data that can be cross-matched on a more efficient and effective basis.

- B. Compare information to department records for all of the entities the Secretary of State reports.

Concur. The department will continue to compare department records with the information the Secretary of State reports. However, as previously mentioned, this is currently an inefficient process as there is not a taxpayer identification number included in these reports. The department will work with the Secretary of State's office to see if they can revise their process to capture a taxpayer identification number.

- C. Implement more effective procedures for identifying and reporting corporation license tax nonfilers and delinquent filers to the Secretary of State as required by state law.

Concur. The department will work toward implementing more effective procedures to identify and report corporation license tax non-filers and delinquent filers to the Secretary of State as required by state law. As previously described this process is limited and inefficient without a common taxpayer identification number to compare data against. A common denominator is necessary to make this exchange of information a worthwhile exercise.

Recommendation #6

We recommend the department:

- A. Comply with section 15-30-112, MCA, concerning the income limitation of dependents other than taxpayers' children.

Concur. The \$800 income limitation has been included in the instructions within the 2006 individual income tax booklet to comply with current law. The department will seek legislation to apply the inflation factor to the \$800 income limitation in future tax years to be consistent with how the department applies the inflation factor to the exemptions provided for in this section of law.

- B. Improve the tax booklet by including all information affecting individual income tax computations contained in state law.

Concur. Sections 15-30-105(2), 15-30-121(1)(i), and 15-30-106, MCA, identified in the audit as laws not included in the 2005 individual income tax booklet have been included in the 2006 tax year booklet. The department is reviewing what can be done to improve

the instructions for someone preparing a return for a taxpayer that is unable to prepare their own as described in 15-30-142(3), MCA. Based on this review, any recommended changes will be included in the 2006 tax year booklet providing that changes can still be made to meet the printing deadlines. If changes to the 2006 tax year booklet cannot be made the recommended improvements will be included in the 2007 tax year booklet.

Recommendation #7

We recommend the department:

- A. Centrally assess cellular phone companies as required by section 15-23-101, MCA.

Concur. The department will conduct interest group meetings with interested parties to move forward with implementing this recommendation. The interested parties will include local and state government as well as affected taxpayers. The discussion will seek the parties' thoughts on such items as implementation timelines, valuation methodology and revenue impacts. The department will begin this process with the intention of implementing the recommendation for the 2007 tax year, while allowing at the same time an opportunity for the 2007 legislative session to review the issue.

- B. Implement procedures and administrative rules to provide consistency in assessing additional penalties for purposely failing to file or pay taxes when due, as required by sections 15-1-216(1)(b) and (1)(d), MCA.

Concur. The department agrees with the recommendation that a consistent approach to assessing penalty and interest for purposely failing to file or pay taxes when due should be taken. To a large degree this consistency will happen through the change in statute which will occur on January 1, 2007. Beginning January 1, 2007 the definition in 15-1-216, MCA, for the penalty and interest provisions applying to purposely failing to file or pay taxes when due will be specifically defined. The department will review the new language to determine if any additional clarity is needed. If so, the department will adopt the appropriate clarity through administrative rule. The department is also proposing legislation to address some of the penalty deficiencies in the current statute. Some of these changes include stricter penalties for non-reporting, non-payment and fraud.

- C. Seek legislation to amend sections 15-1-201 and 15-35-104, MCA, to reflect the department's current information needs from municipal corporations and coal mine operators.

Concur. The department will assess its current information needs from municipal corporations and coal mine operators and seek the necessary changes to existing statute through a general tax revision bill. The language in section 15-1-201(3), MCA, as currently written requires the department to collect specific information from municipal corporations annually, although the department does not deem all of the

information cited as necessary and helpful in performing the work of the department. The department; therefore, will seek legislation to make the statute less restrictive and allow the department to request information as deemed necessary.

The department will also propose legislation to eliminate the requirement in 15-35-104, MCA, for coal mine operators to provide a statement of the tons of coal sold to each purchaser by quarter. This information is no longer required for the enforcement or collection of the coal severance tax.

We appreciate the professionalism demonstrated by your staff that participated in the audit. Thank you again for the opportunity to review the audit report and respond to the recommendations included therein.

Sincerely,

A handwritten signature in cursive script, appearing to read "Dan Bucks", is written over a light gray rectangular background.

Dan Bucks, Director